

**THE REVISED OECD PRINCIPLES OF CORPORATE GOVERNANCE:
A MANAGEMENT ROADMAP FOR HEALTHY, WELL-GOVERNED COMPANIES**

Remarks by
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Development and diffusion of the Principles

1. Good corporate governance underpins market confidence, integrity and efficiency and hence promotes economic growth and financial stability. In promoting better corporate governance, the OECD has since 1999 taken a two track approach: the development of benchmark principles and the active promotion of their use. The OECD Principles of Corporate Governance were issued in 1999 with the purpose to assist governments in their efforts to evaluate and improve their frameworks for corporate governance and to provide guidance for regulators and, more broadly, participants in financial markets. Policy-makers, investors, corporations and stakeholders worldwide have used the Principles to tackle a broad set of relevant issues common to all, such as the need for transparent reporting, informed shareholders and accountable boards. Regional Roundtables on corporate governance set up in partnership with the World Bank have allowed the OECD Principles to become a widely accepted global benchmark that is adaptable to varying social, legal and economic contexts in individual countries. They have helped to spur reforms in regions as diverse as Asia, Latin America, Eurasia, Southeast Europe and Russia.

2. Yet, the recent numerous high-profile cases of corporate governance failure have focused the minds of governments, regulators, companies, investors and the general public on the weaknesses in corporate governance systems and the associated threat posed to the integrity of financial markets. These events have naturally led to the question of whether the Principles had been on the mark or missed something important – or indeed to what extent companies, boards, senior management and investors may have simply failed to follow good practice.

3. The OECD Ministers called in 2002 for an assessment of the OECD Principles by 2004 to take such questions into account. A steering group was set up and intensive consultations were begun with leading business and labour representatives. In addition, comprehensive and transparent consultations with civil society were also organised,

¹ The views expressed in these remarks in no way commit the OECD or its Member countries.

² The 30 OECD Members are the following: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Norway, New Zealand, Netherlands, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States.

culminating in January 2004 with a draft of the revised Principles posted on the Internet for public comment. The Steering Group also conducted a *Survey of Corporate Governance Developments in OECD Countries* to identify lessons learned from experience and possible implications for the assessment of the Principles. This survey and a separate review of *Experiences from the Regional Corporate Governance Roundtables* further informed the review.

4. The revised Principles which have emerged from the review process take account of national experiences and changed circumstances since the Principles were formulated in 1999. Today I would like to discuss some of the most important conclusions of the review which resulted in revisions to the Principles, drawing particular attention to the implications for senior management.

The revised Principles

5. It has become clear from these consultations and research that the benefits of good corporate governance are now widely understood. Good corporate governance is not simply about minimising the risk of corporate failure and dealing with those guilty of fraud. It is also a fundamental prerequisite for improving economic performance, facilitating corporate access to capital, decreasing volatility in retirement savings and improving the general investment climate. These links to investment, public savings, market confidence and integrity make good corporate governance a central policy concern of importance to long-term economic growth and financial market stability.

6. Achieving good corporate governance is not solely the responsibility of the directors, investors and regulators; it should be a core objective of senior management. Poor corporate governance weakens a company's potential and at the worst can pave the way for financial difficulties and even fraud. If companies are well run, they will prosper, which in turn will enable them to attract investors. It is senior management, together with the directors, that sets the governance tone within the company. As was recently said by US Federal Reserve Board Governor, Susan Bies, "senior management must move from thinking about compliance as chiefly a cost center to considering the benefits of compliance in protecting against the legal and reputational risks that can have an impact on the bottom line."³

7. Our review found that the original Principles represented the requirements for good corporate governance reasonably well. The difficulties arose largely in ensuring their effective implementation. The Principles already called for boards capable of independent judgement, yet in case after case the absence of such independence proved fatal. Shareholder rights to appoint board members were supposed to lead to accountable boards, but in the consultations one question repeatedly raised was: where were the informed owners? The Principles called for independent audits which in all too many instances proved a mirage. They called for transparency of ownership structures, but these structures remain opaque in many countries.

³ Susan Schmidt Bies Remarks at the Bank Administration Institute's Fiduciary Risk Management Conference 2004, Las Vegas, Nevada, April 26, 2004.

8. Reflecting the great heterogeneity in both OECD and non-OECD countries, the new Principles retain their non-binding, principles-based approach, which recognises the need to adapt implementation to varying legal, economic and cultural circumstances. Although it was evident that the annotations needed to avoid excessive prescription, the revision responds to the many requests that they should also offer more guidance as to how the Principles could be implemented and enforced through references to evolving practices and perceptions about what constitutes good practice.

9. Responding to experience and the new challenges, the Principles have been advanced in five main areas:

1. ensuring the basis for a sound corporate governance framework, including effective regulatory and enforcement mechanisms;
2. improving the possibilities for the effective exercise of informed ownership by shareholders;
3. enhancing disclosure and transparency, with particular attention to conflicts of interest ;
4. insuring protection for whistle blowers; and
5. tightening the responsibilities of boards.

10. With respect to the first, a new chapter has been added specifying principles for governments to follow in developing the regulatory framework, which underpins good corporate governance. Broad principles have been developed covering implementation and enforcement, and mechanisms that should be established for parties to protect their rights. However, the principles seek to minimise the risk of over-regulation and the costs from unintended consequences of policy action, both of which have been raised by business groups as potential dangers.

11. There is widespread agreement that corporate governance weaknesses in many OECD countries can be attributable to an important extent to a lack of effective ownership. While the original Principles dealt at length with shareholder rights, on the matter of effective participation, they simply noted that all investors, including institutions, should consider the costs and benefits from voting. The revised Principles are more specific, taking the perspective that the costs of voting can and should be reduced, and the benefits in terms of what can actually be achieved from ownership participation must also be improved. Among the elements which seek to strengthen investor voice are:

- The section on shareholder rights has been amended to cover the key issue of board and key executive remuneration. Boards are now expected to formulate and disclose a remuneration policy, highlighting the link between remuneration and performance in the long term. Shareholders should be able to make their views known about this policy and any equity component should be subject to their approval.

- Shareholders should be able to remove board members and their effective participation in the nomination and election processes should be facilitated.
- New principles call on institutional investors acting in a fiduciary capacity such as collective investment schemes and pension funds to disclose their corporate governance policies, how they decide on the use of their voting rights and how they manage conflicts of interest that may compromise their voting. Restrictions on consultations between shareholders, including institutional investors, about their voting intentions should be eased, subject to control of some potential abuses.
- Impediments to cross-border voting should be eliminated.

12. One of the most striking lessons of recent years is that conflicts of interest are widespread and can be quite pernicious. Conflicts of interest, which can and often do lead to actions to the detriment of shareholders, investors and stakeholders, take many different forms so that they are dealt with in several chapters of the Principles. In general, the Principles now advocate not only disclosure but also statements by the parties involved as to how the conflict is being managed. The special conflicts between controlling shareholders and minority shareholders, which are particularly pronounced in a number of developing and emerging market economies, are also explicitly addressed. The provisions include:

- The principles covering disclosure have been strengthened, particularly with respect to conflicts of interest and related party transactions.
- A new principle recognises the role of various providers of corporate information such as rating agencies and analysts whose advice should not be compromised by conflicts of interest.
- The duties of the auditor have been strengthened and include accountability to shareholders and a duty to the company to exercise due professional care in the conduct of the audit. Greater attention is paid to ensuring auditor independence, including steps to manage and to minimise potential conflicts of interest.
- Greater attention is paid to the protection of minority shareholder rights.

13. The Principles have been unique in having a separate chapter devoted to stakeholders and in recognising that a productive relationship is necessary to create value and that this might involve some form of stakeholder participation in the corporate governance process. The approach taken is an enabling one: private parties should not be encumbered in establishing the modalities of cooperation which suit them best. The new issues take up some quite specific stakeholder issues. Particularly important is a new principle to ensure protection for whistleblowers, including institutions through which their complaints/allegations might normally be registered. The chapter on the duties of the board also makes provision for confidential access to someone on the board. The role of employees as a stakeholder is also complemented by new principles which call for an ethical code to be established by the board and for effective rewards and penalties

to be established to ensure compliance with relevant laws and standards. These principles thus serve to clarify and to establish a clear role for employees in the corporate governance process.

14. The stakeholder chapter also breaks with the earlier version in explicitly recognising the role and rights of creditors. In a number of countries the experience has been that poorly defined and ineffectively enforced creditor rights have distorted corporate governance, particularly in the presence of controlling shareholders. A new principle states that the corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights.

15 Finally, the principles covering the structure, operation and duties of the board have been strengthened. Responsibilities have been more clearly specified to cover corporate ethics, compliance with laws and standards, and oversight of internal control and financial reporting systems. The principle covering board and director independence has been extended to cover situations characterised by block and controlling shareholders and not just independence from management. A new principle has been included to the effect that the mandate, working procedures and composition of board committees should be disclosed. The overall responsibility of the board should not thereby be diminished. In the controversial area of the separation of the CEO and Chairman posts, the annotations note that this is increasingly regarded as good practice.

What are the implications for senior management (e.g. CFOs)?

16. While the Principles do not have a separate chapter focusing on the responsibilities of senior management for achieving a high level of corporate governance, it is evident that management has an essential role to play if a company is to meet the governance standards of the revised Principles. I have noted earlier that a key leadership responsibility of senior management is to set the governance tone of the company. The Principles underline the fact that high ethical standards, are in the long term interest of the company: they are essential if the company is to be regarded as being credible and trustworthy. Many companies have found it useful to develop company codes of conduct, often based on professional standards and, sometimes, broader codes of behaviour.

17. The new Principles have important implications for CFO's and their relation with the board and with other sections of management. The board has responsibility for ensuring the integrity of not only the financial reporting system but also for systems of risk management, financial and operational control. Moreover they must also pay particular attention to related party transactions. In doing so the Principles call for the non-executive members of the board to have a special role, and the annotations note that increasingly audit and risk committees are seen as an efficient vehicle for these tasks. The CFO has a crucial role in not only designing and implementing these systems but in also collaborating with the internal auditor to make sure that the systems are functioning. In many companies the reporting line then proceeded through the CEO but the thrust of changes to corporate governance arrangements is that they might also have a direct reporting duty to the board, and indeed a duty to also sign a declaration as to the effectiveness of the systems in place (e.g. as required by Sabanes Oxley). Establishing

effective internal control and risk management systems is vital and standards are being developed. In the US the Committee of Sponsoring Organisations (COSO) has established some highly respected model frameworks in both of these areas, and in the UK the Turnbull Committee report has been incorporated into the combined corporate Governance Code in that country.⁴

Use of the Revised Principles

18. The OECD Principles are deliberately focused on broad corporate governance features rather than detailed prescriptions. This approach to an international benchmark has clear advantages in a field where implementation needs to be adapted to varying legal, economic and social conditions. The success of the Principles therefore relies on their active use in financial markets and the active sharing of experiences regarding effective implementation strategies and 'good-practice' interpretation of the Principles. The OECD will maintain a dialogue with all the parties involved so that everyone can learn from the shared experiences. This is vital to ensuring that the Principles remain relevant and effective, evolving as new issues arise.

⁴ These can be found at the COSO website: www.coso.org and at www.icaew.co.uk/internalcontrol